

entire post-1984 record of the cable industry, from expansions of channel capacity to introduction of new programming, addressability, and fiber belies this assumption.

At a minimum, the acquisition price in a cable transaction reflects compensation for the start-up losses and deferred returns which created the going concern value of the firm, and unrealized economies. It is likely, however, that most of that value has been assigned to intangibles. If the purchaser does not thereafter incur continuing operating losses, no "transition" adjustment is required for moving those acquired assets into regulation, so long as an appropriate amount of the intangibles are accepted into rate base.

Thus, in accounting for the rate base of acquired systems, utilizing the current book value including intangibles, is far more accurate a measure than the seller's "original cost" of tangible assets. The price will already reflect compensation for the seller's losses and some valuation of unrealized economies. To the extent additional losses are subsequently incurred by the purchaser, these should be added as a one-time transitional adjustment to the rate base. To the extent some element of the price is disallowed, it should be amortized over a transition period to provide recovery of cost (without return).

#### 4. "Original Cost" Accounting Problems

Primary resort to the present books of the current owner will also greatly simplify "original cost" accounting. Even for systems originally built by Continental, "cost" records for systems built in the 1960's and 1970's often do not exist. The problem is more acute for acquired systems.

In many instances, the "original" cost is lost in records which were never transferred at the time of acquisition. Under APB-16 guidelines, which cover business combinations, an asset acquired is recorded at the cost of the cash disbursed or the fair value of the assets provided as consideration. APB-16, ¶67 (subparts (a) and (c) provide that assets acquired by exchanging cash or other assets are recorded at "cost," defined as the amount of cash disbursed for the fair value of the other assets distributed or, if acquired for shares of stock, the asset is recorded at the fair value of the shares.

Moreover, ¶87 of APB-16 provides that all identifiable assets acquired in a business combination shall be assigned a portion of the cost of the acquired company, normally equal to their fair value at the date of acquisition. These principles illustrate the difficulty in applying "original cost" of the first person to dedicate property to public use in the regulation of subsequent owners. Proper accounting for cable acquisitions would require a restatement of the books to the fair value cost of the system at the time of purchase.

As a consequence, "original cost" valuation (as the Commission has construed it) is simply impractical for most systems which have changed ownership. Buyers typically followed GAAP in accounting for acquired systems, and therefore did not maintain records of the seller's costs. Systems now in existence bear no resemblance in most situations to original systems. Improvements and purchases made over many years would make it burdensome and unreasonable to trace costs back to their "origin."

Moreover, restating the gross assets would be only the first step of the process. Existing depreciation reserves would, as noted by the Commission, need to be restated to match the new value of the assets. Otherwise, one may find that depreciation exceeds the supposed "cost" of the assets, and the Commission would face the problem encountered in regulating entities with vastly understated ratebases.<sup>24/</sup>

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<sup>24/</sup> The operating ratio method of ratemaking sets revenues as profits over expenses and has been employed by regulatory bodies to enable regulated companies to earn a fair return on their investment. See, e.g., Hamm v. South Carolina Pub. Serv. Comm'n, 422 S.E.2d 118, 122 (S.C. 1992) (water and sewage utility); Parks v. Rent Control Bd., 526 A.2d 685, 686 (N.J. 1987) (rent control); Hamm v. South Carolina Pub. Serv. Comm'n, 344 S.E.2d 600, 602 (S.C. 1986) (motor carrier services); Public Serv. Comm'n v. Dewitt Water Dist., 720 S.W.2d 725, 729 (Ky. 1986) (water utility); State Ex. Rel. Util. Comm'n v. Public Staff, 343 S.E.2d 898, 901 (N.C. 1986) (water utility); Texas Indus. Traffic League v. Railroad Comm'n, 683 S.W.2d 368, 369 (Tex. 1984) (railroad); State, etc. v. Intervenor Residents, etc., 278 S.E.2d 761, 766-67 (N.C. 1981) (water and sewer utility); In the Matter of Wilmington Suburban Water Corp. for a General Increase in

[Footnote cont'd.]

Regulators originally shifted from fair value to original cost as an available and better estimate of the amount of invested capital, but only after utilities had been subject to rate of return regulation for 20 to 50 years. The best measure of invested capital in the cable industry is current books of account, adjusted for operating losses and deferred returns. Only that treatment will satisfy the fundamental legal obligation to value the rate base equitably.

D. A Transitional Adjustment is Mandatory

The transitional adjustment that Continental proposes is consistent with the underlying objectives of rate regulation and with a fair reading of compensation doctrine.

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[Footnote cont'd.]

Rates, Slip Op. No. 82A-JN-6 (Del. 1982) (water utility); Moore v. Arkansas Transport Co., 606 S.W.2d 575, 576 (Ark. 1980) (transport company); Casco Bay Lines v. Public Util. Comm'n, 390 A.2d 483, 490-91 (Me. 1978) (shipping); Guida v. Public Util. Comm'n, 348 A.2d 613, 617 n. 4 (Conn. 1974) (motor transit companies); Commonwealth v. Federal Maritime Comm'n; 468 F.2d 872, 874 (D.C. Cir. 1972) (shipping); D.C. Transit Sys. v. Washington Metro. Area Trans. Comm'n., 350 F.2d 753, 759 (D.C. Cir. 1965); Florida Rate Conference v. Florida Railroad and Pub. Util. Comm'n, 108 So.2d 601, 603 (Fla. 1959) (common carrier motor freight lines).

1. Accumulated Cable Losses Are Different  
In Kind From Regulated Utility Losses

Past losses of traditional public utilities normally cannot be used to strike down a reasonable or otherwise compensatory rate.<sup>25/</sup> Similarly, past losses of traditional public utilities also cannot be capitalized as property upon which a fair return is based.<sup>26/</sup> However appropriate that rule may be for industries long subject to rate regulation and given a wide opportunity for current earnings, it is not appropriate for an entrepreneurial business which has built a going concern only after great losses, at great risk, and which owes a return to its investors for the entire period of their investment. Moreover, where the losses are more properly characterized as necessary deferred start-up costs incurred in the establishment of a business, those costs should be recoverable in the rate base.

For example, Continental systems maintain detailed records of the subscription patterns of particular neighborhoods, and even individual subscribers with respect to premium channels and pay-per-view events. In addition, Continental has extensive employee training and community outreach programs which help the

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<sup>25/</sup> Los Angeles Gas & Elec. Corp. v. Railroad Commission, 289 U.S. 287, 313 (1933); Galveston Elec. Co. v. City of Galveston, 258 U.S. 388, 395 (1921).

<sup>26/</sup> Georgia Railway & Power Co. v. Railroad Comm'n, 262 U.S. 625, 632 (1922).

company to forge relationships with its customers. Intangibles such as these transform spools of fiber and coax and purchase orders from equipment suppliers into a dynamic and innovative, customer and community-responsive, entertainment and information business.

There is no evidence that Congress sought to exclude the value of intangibles in valuing cable firms. Indeed, in the one instance in which Congress has expressed its understanding of the value of cable television systems, it provided that, unless a franchise is revoked for cause, cable television systems be valued at "fair market value, determined on the basis of the cable system valued as a going concern...". 47 U.S.C. § 627. This section was not amended or changed by the 1992 Cable Act.

It has long been recognized that the rate base encompasses much more than the physical assets comprising the regulated company's business. "The thing devoted by the [regulated company] investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the capital so invested, the Federal Constitution guarantees to the utility the opportunity to earn a fair return." Missouri ex rel Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 277, 290 (1922) (Brandeis, J. concurring). While the D.C. Circuit has stated that Justice Brandeis' formula for computing the rate base by

inclusion of prudently invested capital has not become the prevailing rule, "the central idea that the investor's legally protected interest resides in the capital he invests in the utility rather than the items of property which the capital purchases for provision of utility service [has prevailed]."

Democratic Cent. Comm., 485 F.2d at 801.

Regulatory authorities have recognized that start-up and post start-up losses must be added back to rate base in order to properly account for the characteristics of the cable industry. For example, the Massachusetts Cable Television Commission held that

These operating losses are properly allowable in the rate base because they represent funds prudently invested in the construction and maintenance of the system at the time when the bulk of expenditures had to be made. . . . A policy specifically prohibiting the opportunity to earn a return on these funds would jeopardize the economic viability of systems that have experienced substantial prior losses . . . [and] might have a chilling effect on the development of cable in Massachusetts.

Stan-Fran Corp. in Haverhill and Groveland, Docket No. AFD-10, AFD-24 at 5 (Mass. Community Antenna Tel. Comm'n, Feb. 17, 1977).

Cable operators who have deferred prior returns in order to grow their systems and reinvest in plant for long-term growth should not now be penalized because these assets are made subject to regulation.<sup>27/</sup> Democratic Central Committee (which

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<sup>27/</sup> During the eight year period (1985-1992) following passage of the 1984 Cable Act, Continental invested \$1,146,457,000

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the Commission has endorsed in its Joint Cost Allocation Order) acknowledges that gains and losses must be equitably allocated when assets are transferred out of regulation.<sup>28/</sup> Thus, when assets are transferred out of regulation, ratepayers are entitled to reap the fruits of investment for which they have borne the risk. Conversely, when assets are transferred into regulation, prior losses should be borne by the ratepayers who have benefited from them.

Because cable operators' investment in their businesses extends far beyond physical plant and property investment, and because the unrecovered accumulated costs represent a significant part of such capital investment, they should be included in cable operators' cost of service rate base.

These start-up expenditures, and other costs associated with operations have been defined in the traditional public utility context as the difference in value existing between a plant in successful operation and a similar plant assembled but not yet functioning.<sup>29/</sup> Cable operators should be permitted a

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[Footnote cont'd.]

in property, plant and equipment additions to upgrade, rebuild and expand systems. Over its entire 30-year history, Continental has never paid a dividend to its shareholders.

<sup>28/</sup> Democratic Cent. Comm., 485 F.2d 786.

<sup>29/</sup> See Willcox v. Consolidated Gas Co., 212 U.S. 19 (1909).



return on the going concern value of their businesses. Indeed, the Commission has explicitly permitted a rate-regulated carrier to include its deferred start-up costs, a significant portion of the going concern value, in its rate base.<sup>30/</sup>

2. Continental's One-time Adjustment is Comparable to the Proper Treatment of Plant Under Construction and Interest During Construction

Adding past start-up losses and deferred returns to the rate base is comparable to the Commission's treatment of Interest During Construction ("IDC"). To the extent plant under construction has not yet been included in the rate base, a telephone company has incurred actual financial costs, and is allowed IDC.

Similarly, where cash recovery through rates is not provided, electric utilities are allowed to accrue as income an amount equal to the debt and equity cost of financing construction of that new plant as it is built. Without such accounting, the utility's income would be drastically affected during construction. After the plant is operational, the plant costs, including interest accrued as Allowance for Funds Used During Construction ("AFUDC"), are included in the rate base and recovered through depreciation in rates. In many cases, if

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<sup>30/</sup> Communications Satellite Corp., 56 F.C.C.2d 1101, 1184 (1975), remanded on other grounds, Communications Satellite Corp. v. F.C.C., 611 F.2d 883 (D.C. Cir. 1977).

construction of the plant consumes many years, the amount of AFUDC will be quite significant.

The one-time cable transitional adjustment will "true up" the rate base by adding back the equivalent of plant under construction ("PUC") (the actual start-up losses in creating a system as a going concern) and IDC (deferred returns).

3. Cable Acquisition Prices Do Not Reflect Collusion

The traditional presumption against including an acquisition premium in a utility's rate base may be appropriate for utilities long subject to rate base rate of return regulation. Without that rule, sellers and buyers would have a common interest: if buyers pay an inflated purchase price, the amount would still be recoverable from ratepayers when included in the rate base. Accordingly, when a seller realizes a value above that reflected on its books which could not previously be reflected in rates, the sale can reward the seller and allow the buyer to adjust rates upward to reflect this premium. "The acquisition of the property of one utility by another utility presents the possibility for abuse, or at least confuses the question of the proper value to be placed on such property for ratemaking."<sup>31/</sup>

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<sup>31/</sup> Illinois Bell Tel. v. F.C.C., 911 F.2d 776, 784 (D.C. Cir. 1990) (quoting In Re Amendment of Parts 65, 4 F.C.C.Rcd.

[Footnote cont'd.]

Moreover, even the presumption against including acquisition premiums in a utility's rate base may be overcome by a showing that the transaction was arms length and served the public good by benefitting customers. Re Indianapolis Water Co., etc., 75 PUR 4th 643, 655 (Ind. Pub. Serv. Comm'n 1986); Re Peoples Gas Sys., Inc., 119 PUR 4th 252 (Fla. Pub. Serv. Comm'n 1990). For example, in Re Application of Northeast Utilities/Public Service Co. of New Hampshire, 114 PUR 4th 385, 414-416 (N.H. Pub. Util. Comm'n, 1990), the New Hampshire PUC permitted inclusion of the total purchase price including the "Acquisition Premium" in the rate base. The "public good" standards which justified that inclusion were that the assets were operated as an integral part of the buyer's system; the buyer could provide necessary capital to finance system operations; the buyer could furnish engineering, accounting and other management services; and the buyer could more economically operate the system. Ibid at pp. 415, 416. Much of the reasoning

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1697, 1704 (on reconsideration) (1989)). However, even in the regulated utility situation, when an asset is acquired from a non-affiliated carrier, acquisition premiums may be included "when the price of an asset is determined by an arm's length transaction in the normal course of business, we believe there is reasonable assurance that the price paid would not be manipulated to the detriment of ratepayers. We see no incentive for a carrier to inflate the ratebase in such situations." In the Matter of Amendment of Part 65, 7 F.C.C.Rcd. 296, 299 (1991) (on remand).

applies to clustering of cable systems and the type of public good or customer benefit that flowed from many acquisitions.

1980's cable acquisitions took place in markets where no collusive pricing was possible. Neither buyer nor seller were subject to rate base rate of return regulation. Purchasers sought the lowest possible price, and had interests quite adverse to sellers. Both buyers and sellers also had fiduciary responsibilities to investors. There is no evidence that the transactions reflected anything other than fair, arm's length, negotiated prices. Indeed, most of the purchase prices in the 1980's were supported by third party appraisals after careful due diligence of the systems being acquired. Nothing in the record suggests that the prices were inflated in a conspiratorial manner to defeat regulatory discipline, in the manner of electric utilities before regulation. Thus, there was no motive or economic incentive to artificially inflate rate base, and no basis for retroactively applying a rule intended as a prophylactic against such artifice.

4. Disallowance of Start-up Losses and Deferred Returns Is Unconstitutional

If the Commission disallows actual expenses incurred or prevents the recovery of or return on various intangibles, the Commission's action would retroactively deprive cable operators of the benefits of investments made in years prior to regulation. This would violate the Takings Clause of the Fifth Amendment.

The Takings Clause of the Fifth Amendment forbids the government from taking property from public use without paying just compensation to the owner. Nixon v. United States, 978 F.2d 1269, 1275 (D.C. Cir. 1992). Retroactive application of the Cable Act so as to prevent the recovery of, or return on, various investments made by cable operators in the years prior to regulation would constitute a per se taking of that property without just compensation because it would destroy the cable operators' rights in that property.<sup>32/</sup> In this situation, retroactive application that prevents or precludes recovery of various items of capital committed to cable systems would deprive Continental and other cable operators of their property in violation of the Takings Clause of the Fifth Amendment.<sup>33/</sup>

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<sup>32/</sup> There is no question that items accounted for as "intangibles" constitute protected property interests. Soranno's Gasco, Inc. v. Morgan, 874 F.2d 1310, 1316 (9th Cir. 1989); Marrero v. City of Hialeah, 625 F.2d 499, 514-15 (5th Cir. 1980), cert. denied, 450 U.S. 913 (1981).

<sup>33/</sup> See, e.g., In re Walkers Mill Inn, Inc., 117 B.R. 197, 199-200 (Bankr. W.D. Pa. 1990); Campbell v. United States, 809 F.2d 563, 571 (9th Cir. 1987).

#### E. Plant Under Construction

The cable industry is in the midst of a dramatic revolution entailing significant construction costs: it is shifting from coaxial cable to fiber; from analog to digital; and is renewing the bulk of the franchises awarded during the late 1970's and early 1980's. The soundest means for assuring cable's ability to upgrade its plant and meet renewal obligations is to allow plant under construction into the rate base when construction begins. If construction is contemplated over more than one year, all of the PUC should be included, as the Commission has recently proposed for the telephone industry in CC Docket 93-50.

If this treatment is afforded, then the Commission's suggestions for alternative test years (¶55) are best resolved by use of a historical period adjusted by the operator to allow for the pro forma effects of known and measurable changes. Thus, a rebuild -- which usually involves a fairly high percent of embedded plant -- could be given pro forma effect in a cost of service case which anticipates commencement of the rebuild.

The Commission suggests that an allowance for plant costs might be limited due to "excess capacity." (¶42-43). In fact, the channel capacity of cable systems today are not "excessive;" to the extent there is available capacity, it is

because systems are upgraded in "lumps." Cable operators can upgrade from 450MHz (62-channels) to 550MHz (78-channels) for almost the same cost as adding just a few channels. Indeed, one would be hard-pressed to find equipment which does not increase system capacity in large increments. Fiber deployment entails the same (capitalized) labor charges regardless of the number of strands in the sheath. The principal cost in cable construction is labor. Indeed, the cost of building 550MHz plant is only 10-15% greater per aerial mile than the cost of building 450 MHz plant. The fact that not all channels are immediately programmed simply reflects the continual development of new cable programming and an effort by operators to retain some channels for new services. All cable plant is usually activated. The headend, with perhaps the addition of some modulators, is fully functional and in service. All cable plant in service could be used to provide additional programming to subscribers on short notice if sufficient demand existed to consume the capacity now held in reserve. By contrast, telco equipment loop utilization factors have been persistently declining since divestiture.<sup>34/</sup>

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<sup>34/</sup> Although telco deployment of fiber has increased since divestiture, the number of circuits that can be multiplexed onto the same fiber changes as terminal and repeater technologies improve. Therefore, the same underlying fiber data from prior years can be updated to estimate maximum available capacity. For example, new terminal technology supports almost 25,000 two-way circuits on a single fiber pair, more than triple the capacity of earlier systems. Because carriers are accurately aware that upfront costs for

[Footnote cont'd.]

Considering that the Commission and Congress seek to encourage the deployment of new technologies, Continental believes that it would be best for the Commission to initially monitor cable channel capacity, rather than attempt premature disallowances of channels presently held in reserve.

F. Working Capital

Working capital is defined as follows:

The average amount of capital provided by investors in the company over and above the investment in plant and other specifically identified rate base items, to bridge the gap between the time expenditures are required to provide service and the time revenues are received for that service.

Components of working capital are generally material and supplies inventories, prepayments, and cash working capital. Cash working capital usually garners the most attention and has been the most controversial because three different methodologies have developed and been used by regulatory agencies: the Lead-Lag study, balance sheet approach, and formula methodology. It would be appropriate for the FCC to adopt the formula

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[Footnote cont'd.]

fiber deployment in absolute terms are high, a significant portion of the total investment can be deferred until demand materializes. Fiber Deployment Update -- 1992 (Released Apr. 30, 1993) at 2.



methodology to provide cable operators cash working capital needed to pay operating expenses and maintain appropriate cash balances.

The formula methodology developed as a reasonable proxy of Lead-Lag study results without the exorbitant expense, hearing time and controversy involved in reviewing the detailed, controversial study. As the name implies, the formula methodology calculates 1/8 of operation and maintenance expenses (45 days divided by 365) for cash working capital requirements.

The FERC utilizes the formula methodology, recognizing its validity and ease of use.<sup>35/</sup> The FCC considered cash working capital methodologies in Amendment Of Part 65, 3 F.C.C.Rcd. 269 (1987). After approving the Lead-Lag study in its initial 1987 order, the FCC reconsidered its appropriateness and adopted the formula approach, recognizing that cost savings warranted the slight reduction in precision achieved. Although the FCC has approved the Lead-Lag study approach to cash working capital in interstate carrier cases, cable operator regulation is intended to be less cumbersome and technical than that of interstate carriers.

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<sup>35/</sup> Middle South Energy Inc., ER82-616-000, 1984 FERC LEXIS 3396 (1984).

Clearly, the FCC has expressed interest in streamlining the cost of service option under cable operator regulation. The formula approach is consistent with that goal, utilized by other regulatory agencies, adopted in the past by the FCC and should also be adopted for cable operators.

V. CALCULATING THE RATE OF RETURN

The appropriate rate of return methodology for the cable industry must satisfy two fundamental needs: first, it must fully account for the differences between the terms, conditions and costs of financing for the cable industry versus the telephone industry; second, it must guarantee investors the opportunity to be appropriately compensated on a current basis. Continental understands the intense time pressures on the Commission and the temptation to borrow heavily from telephone precedent in establishing the return element. However, the financial characteristics of the cable industry preclude wholesale importation of the methodology previously used to establish telephone return.

A. Relative Risks of Cable Investment

On the fundamental level of comparability, the telephone industry resembles cable principally because it has capital intensive plant hanging on utility poles. But beyond that, the risks associated with cable firms are considerably

greater than those associated with an investment in an LEC. As a result, several features of the Notice regarding development of an appropriate rate of return for cable firms are either not applicable to cable or not workable. The Notice [¶¶46-53] discusses the process by which the Commission will identify the rate of return allowed cable operators under cost of service regulation. Continental agrees with the Commission that this process should be governed by careful consideration of the standards and practices used in setting rates of return for other regulated firms, provided the Commission accounts for the significant differences between cable companies and other businesses. The appropriate rate of return allowance will be a key determinant of the financial performance of firms in the cable industry.

Continental also preliminarily agrees with the Commission's assessment [¶46] that establishing an industry-wide rate of return would be highly preferable for the efficient administration of the cost of service rules by all stakeholders. The Commission also should reduce costs on itself, the industry and subscribers by utilizing a common capital structure for cable operators, one that reflects reasonable, forward-looking capitalization requirements as the industry simultaneously matures, adapts to re-regulation and confronts competition on several fronts. An objective capital structure of 50% debt and 50% equity, as used in the Notice, would accomplish this

objective. As an alternative, it may also be possible for the Commission to specify an average capital structure typical of a set of comparable firms in an industry composite group. However, extreme care must be taken to establish the underlying rate of return methodology so as to recognize unique features of the cable industry.

As discussed below, Continental agrees with paragraph 50 of the Notice that composite measures, like the S&P 400, will provide a correct starting point for this assessment. The Commission's experience with setting authorized returns for regulated telephone companies also may be particularly helpful to illustrate the very risk differences that distinguish cable regardless of the seeming similarity of the two industries. However, other parts of the proposed rate of return methodology such as the use of the same discounted cash flow (DCF) methods applied to telephone companies or using an "investment cycle" approach are not workable and should be replaced, at least during the early years of cable cost of service regulation, with benchmark-like risk premium calculation based upon rates actually paid in competitive capital markets.

Continental believes that any FCC approach such as this must fully account for the differences between cable and other stocks. Investors in cable equities know that at any point in time the value of their shares may differ greatly from their

purchase price. These price variations substantially exceed those for investment-grade utility stocks and broad portfolios of stocks such as the S&P 400. Likewise, issuers of cable debt securities know they must incur a significantly higher premium over a risk-free investment, and that they must attempt to secure those premiums by means of covenants and conditions that are far more restrictive than the comparable requirements for the lower-yielding debt of less risky businesses. Chart 1, prepared by Morgan Stanley and Co., Inc., clearly depicts the fluctuations in cable stock prices as compared with the Regional Bell companies and the S&P 400 stock prices for the last ten years.<sup>36/</sup>

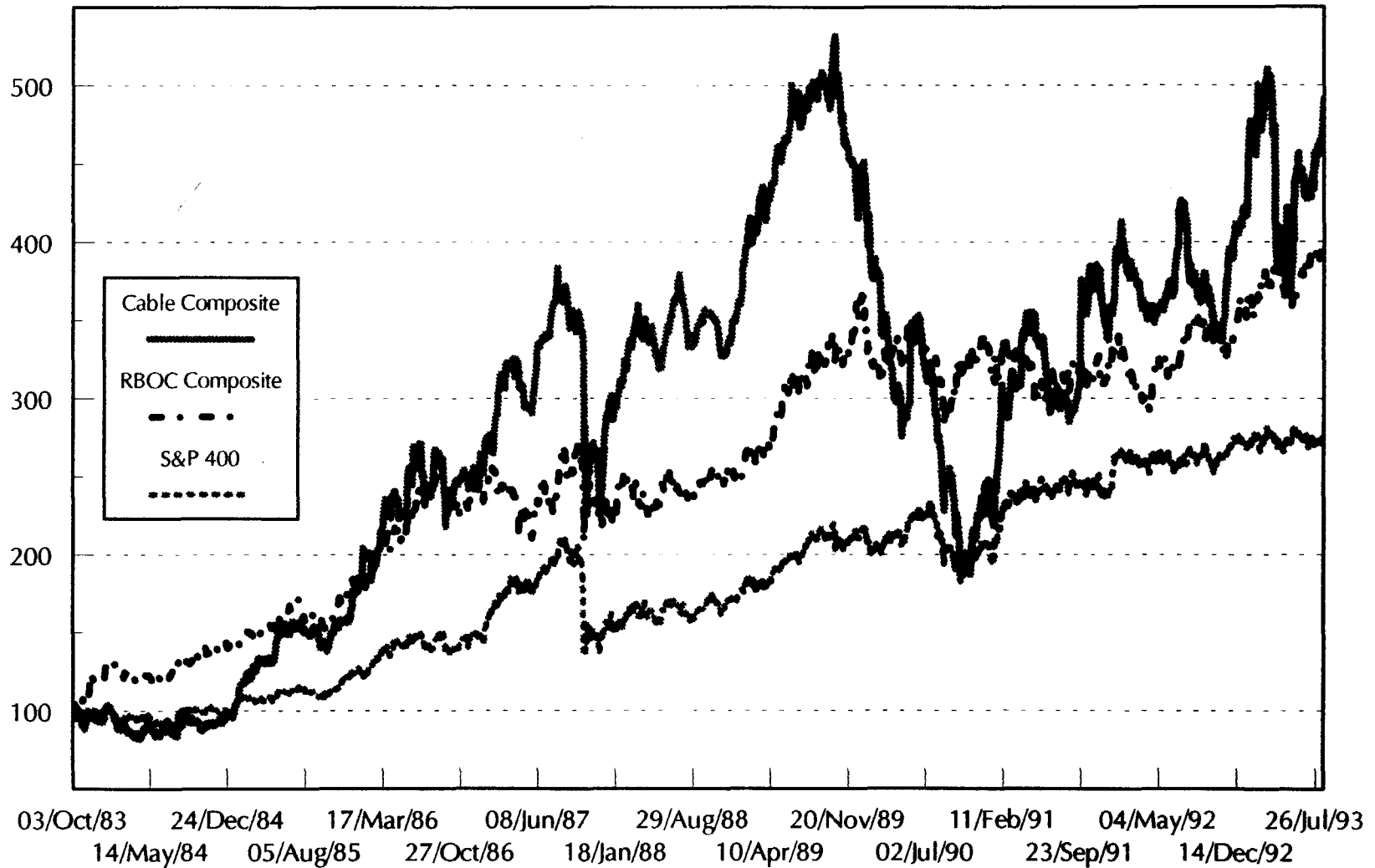
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<sup>36/</sup> The variability of the equity betas for the cable and telephone industries shown on Chart 1 is, of course, mirrored in the performance of the stock prices of individual firms. Beta measures the level of changes of a firm's stock in comparison to overall changes in the market, as a means of isolating the risk associated with investment in that firm as opposed to the general risks associated with the market.

## Price in USD Indexed to the First Period

3-Oct-83 to 17-Aug-93

Indexed Price



Source: Morgan Stanley & Co., Incorporated

The chart "Price in USD Indexed to the First Period" (Chart 1) provides preliminary support for the Commission's assessment of cable equity returns in comparison to the highest quartile of the S&P 400 [¶ 52] because the differential between cable betas and the S&P 400 average has substantially exceeded the differential for telephone companies through all of the last ten years.

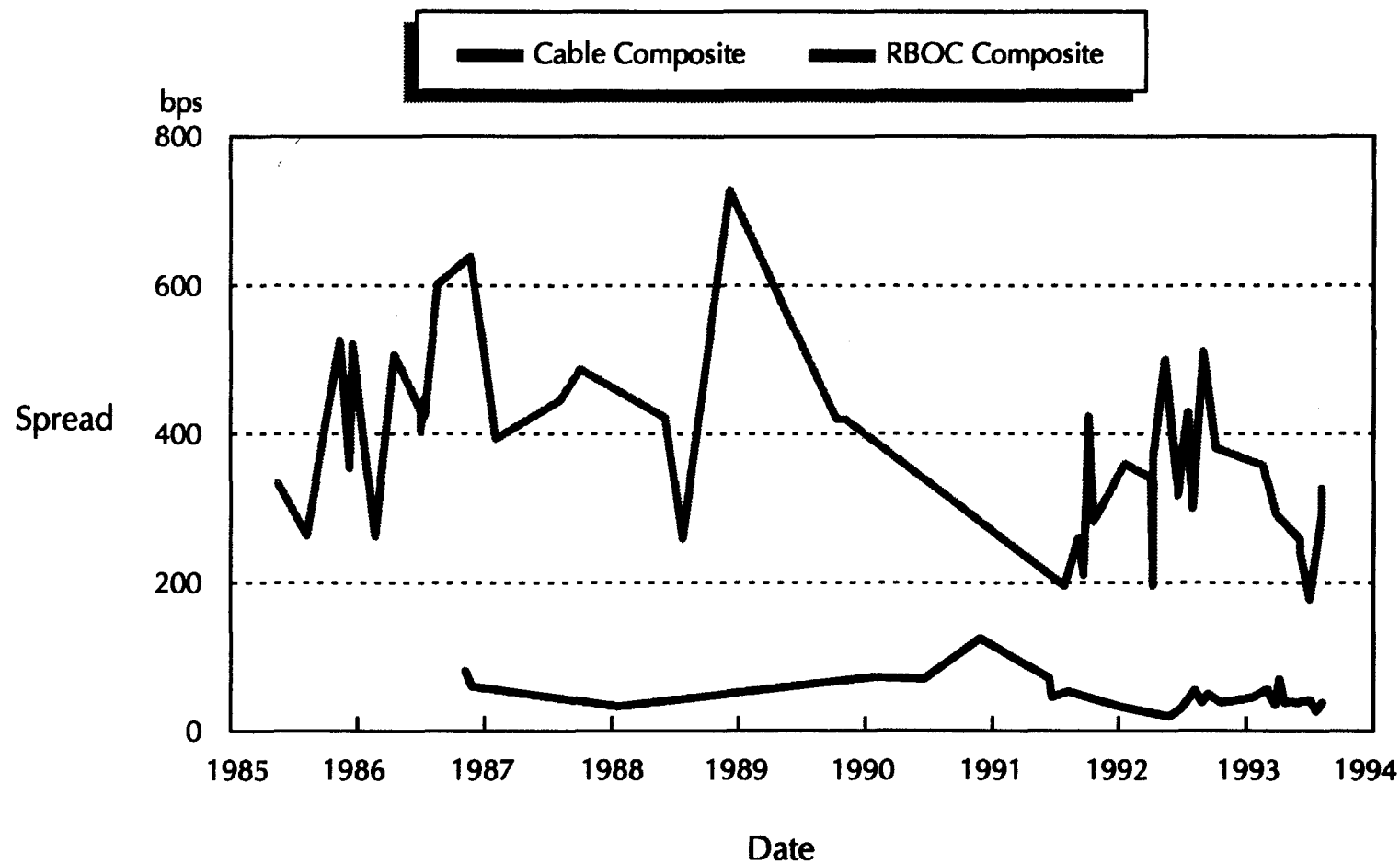
The Notice (¶52) also requests comments on the relative risks of cable companies compared to S&P 400 or other companies. Continental believes that a risk premium for the cable industry should account for cable's own yield spread above a comparable measure like "Aa" bonds or the risk free rate provided by U.S. Government securities of comparable maturities. In addition, however, the Commission's assessment should account for two other factors that may be overlooked in risk premium calculations involving multiple-year, multiple-industry composite measures: (1) Historically, cable firms have faced far greater year-to-year variations in debt yields than industries such as the telephone industry. (2) At any given point in time firms in the cable industry must operate with substantially greater restrictions on their business imposed by suppliers of debt funds. These factors mean that, unlike firms in other capital-intensive industries, cable operators may have to enter capital markets at periods when expected yields are at peaks, and they usually do have to accept

more restrictive covenants. But, given the rapid evolution in technology that operators must accommodate and the well-recognized threats of increasing competition, they are unable to delay or defer critical access to capital markets. In short, the cable operator's risks are not only that it must pay more to attract capital but that the terms and conditions by which such capital are offered are highly varied over time and much more restrictive.

The variability over time of the composite spread between comparable cable debt issues and regional telephone company debt is illustrated in Chart 2-A and 2-B. The variations in cable spreads compared to the risk-free rates of comparable Treasuries are far more dramatic than those faced by telephone companies. If cable operators could forego raising new debt capital when the spread becomes too large, the industry would still incur a very substantial risk premium of at least the order suggested in ¶ 52. Unfortunately, no cable operator today enjoys the luxury of avoiding the debt market when the cost of equity is more expensive.



## Comparison of Historical Spreads to Ten Year Treasury



Source: Morgan Stanley & Co., Incorporated